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FRBNY Letter from John J Ruocco to Board of Directors of Citigroup Re Annual report of inspection

John J. Ruocco

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FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, N.Y. 10045-0001

AREA CODE 212-720-5000

April 15, 2008

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BY HAND

Board of Directors
Citigroup Inc.
c/o Vikram Pandit, CEO
399 Park Avenue
3rd Floor
New York, NY 10043

Dear Board Members:

Enclosed is our annual report of inspection for Citigroup Inc., as of December 31, 2007. The report conveys our overall assessment of the firm, using the Federal Reserve's RFI/C (D) rating for bank holding companies.[1] Our findings are based on continuous monitoring efforts, target examinations conducted throughout the year, and assessments made by other primary bank and functional regulators.

We have assigned a rating of 332/3 (3) to Citigroup. Our overall composite assessment of the firm reflects a downgrade to fair or "3" from satisfactory at the previous inspection. Institutions so rated reflect a combination of weaknesses in risk management and financial condition that range from fair to moderately severe. They are less resistant to the onset on adverse business conditions and would likely deteriorate if concerted action is not taken. Consequently, they require more than normal supervisory attention and surveillance.

In assigning the overall fair rating, we now consider the risk management of the firm also to be only fair or "3," a downgrade from satisfactory at the previous inspection. This reflects serious deficiencies in Board & Senior Management oversight, policies/procedures/limits, monitoring & MIS, and internal controls. These weaknesses were apparent from the significant losses the firm experienced in its handling of risk posed in certain of its structured credit businesses, in its leveraged lending activities, and in the manner which the firm managed its balance sheet.

We also consider the financial condition of the firm to have deteriorated from strong to fair, or "3." This downgrade in the financial rating reflects our assessments of its various subcomponents.

[1] The components of the RFI/C(D) rating system are risk management, financial condition, likelihood of a negative impact of the parent and non-bank subsidiaries on the depository institutions, an overall composite, and a depository institution rating. All components use a scale of 1 to 5, ranging from strong to unsatisfactory.

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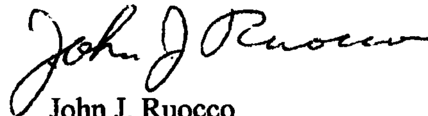
Earnings are considered only marginal or "4," while capital and liquidity have been downgraded to fair or "3." These reassessments take into account the likely financial stresses the organization will face in the coming months and the uncertainty of its future earnings in the near-to-medium term future. Asset quality at the firm has been downgraded to satisfactory or "2" reflecting the negative trend in the portfolio's stock of assets. It will require close monitoring and aggressive management going forward. We continue to view the likelihood of a potential negative "impact" that the non-depository entities could have on the subsidiary depository institutions as limited or "2."

Details of these findings are contained in the enclosed report and will be discussed with you during our scheduled meeting of April 21, 2008. Because of the nature and seriousness of the overall weaknesses, it is our intention to enter into an enforcement action with the firm, whereby both Citigroup and the Federal Reserve System agree on remedial action that must promptly be taken. The terms of the enforcement action will be submitted to you shortly for review.

After you have had an opportunity to review this report, and within 60 days of the receipt of this letter, we would appreciate receiving management's written response to the matters discussed in the report. Please note that this letter and enclosures contain confidential bank examination material and should be treated accordingly by your organization as described in the footnote.[2]

Respectfully,



John J. Ruocco
Asst. Vice President

Enclosure

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SUMMARY OF SUPERVISORY ACTIVITY AND FINDINGS

Name: CITIGROUP

Period Covered: January 1, 2007 – December 31, 2007

Location: NEW YORK, NEW YORK

RSSD ID Number: 1951350

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OVERALL COMPOSITE RATING

In general, our findings reveal weaknesses in Citigroup's overall condition such that its composite rating is considered to be "fair" (or rated 3).[1] At the heart of our assessment are weaknesses in **risk management** pertaining to how it handled exposure in several areas of its business, namely (1) Structured Finance and particularly in its approach to capturing direct and indirect exposure to subprime mortgage-related CDOs, (2) leveraged finance, and (3) balance sheet management. Details are discussed in the Risk Management section of the report. While the new management team at Citigroup has begun to take steps to address these weaknesses and improve risk management at the firm, especially in the manner in which risk is measured and communicated upward to senior management and the Board, it is critical that this remain a high priority and extend to effecting changes throughout the organization.

Our overall assessment also reflects deterioration in the **financial condition** of Citigroup. The firm suffered severe losses in 2007, and is expected to announce 1st quarter losses as well. Projected earnings for full year 2008 are uncertain, but are not likely to be sufficient, given deteriorating credit market and general economic conditions, to sustain existing capital adequacy levels without management taking additional mitigating actions. Accordingly, management must strongly consider the range of actions it may need to take over the course of the coming year to ensure healthy capital levels, including the raising of additional capital, considering its common dividend, and managing even more tightly asset growth and divestitures. Further, in its capital planning process, management and the Board of Directors need to assess the implications of the uncertainty surrounding the firm's ability to generate strong and consistent earnings on the firm's capital. As currently forecasted, earnings may not be sufficient to meet the expectation embedded in Federal Reserve policy that common dividends be funded from current earnings. The capital plan must account for this uncertainty, and management needs to be prepared to take quick, decisive action to maintain a sufficient capital buffer.

The difficult financial circumstances in which the firm finds itself have also strained its liquidity at both the bank and consolidated levels. The increase in the asset levels, combined with difficulties in funding markets, have resulted in increased reliance on short term funding and less options to address any additional funding stresses. Additional strains can develop in the event of an adverse market reaction to further losses or if there were to be additional downgrades by rating agencies. While the firm has appointed a new Treasurer, and has begun taking steps to enforce greater discipline in the funding process and centralize the Treasury function, the firm needs to take additional steps to alleviate structural liquidity pressures and build ample liquidy that can withstand unexpected disturbances.

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[1] Bank holding companies rated "fair" exhibit a combination of weaknesses in risk management and financial condition that may range from fair to moderately severe. The company is considered to be less resistant to the onset of adverse business conditions and may likely deteriorate if concerted action does not correct the areas of weakness. Companies rated fair require more than normal supervisory attention and financial surveillance. However, the risk management and financial condition of the firm, including the potential negative impact from the non-depository institutions, pose only a remote threat to its continued viability.

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In light of the above, we have intensified our monitoring of the firm, and may take additional supervisory action to insure the firm is able to continue to serve as a source of strength to its depository institutions.

RISK MANAGEMENT

The risk management rating represents an evaluation of the ability of Citigroup's Board of Directors and senior management, as appropriate for their respective positions, to identify, measure, monitor, and control risk across the bank holding company and its subsidiaries. The rating is supported by four subcomponents: Board and Senior Management Oversight; Policies, Procedures and Limits; Risk Monitoring and Management Information Systems ("MIS"); and Internal Controls.

Risk Management Ratings for Citigroup	**12/31/07**
Overall Risk Management Rating	3
Component Ratings:	
Board and Senior Management Oversight	3
Policies, Procedures, and Limits	3
Risk Monitoring and MIS	3
Internal Controls	3

Summary of Risk Management Conclusions

The assessment of Citigroup's overall risk management has been downgraded from "satisfactory" to "fair."[2] It primarily reflects weaknesses in the firm's setting and monitoring of its risk appetite and exposures that led to severe and unexpected losses in its Markets and Banking ("CMB") businesses. These weaknesses were characterized by a

[2] This assessment signifies that risk-management practices are lacking in some important ways and therefore are a cause for more than normal supervisory attention. One or more of the four elements of sound risk management are considered less than acceptable and has precluded the institution from fully addressing one or more significant risks to its operations. It signifies that certain risk management practices need improvement to ensure that management and the board are able to identify, monitor and control all significant risks to the institution. The risk management weaknesses could have adverse effects on the safety and soundness of the institution if corrective action is not taken by management.

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failure of risk management systems, personnel, senior management, and the Board of Directors to identify potential risks and properly weigh them against the firm's risk appetite. Senior management, the independent Risk Management function, and the Board of Directors did not appropriately anticipate the magnitude of potential financial losses, nor weigh risk-adjusted returns along with actual and potential balance sheet usage that these businesses could require. Further, senior management at the firm allowed its drive for additional revenue growth to eclipse proper management of risk, while Risk Management failed to serve as an effective check against these decisions.

Management did not correctly identify and assess its concentration to subprime risk exposures in its CDO trading book, which produced significant losses that severely eroded the firm's capital and its reputation. Although possessing a complex risk management infrastructure, the firm did not capture through appropriate stress testing or other adequate risk metrics the full potential for market write-downs in CDO structured credit products. Furthermore, the CMB Risk Management Committee did not provide adequate oversight of the growing subprime CDO concentration.

The firm did not properly address the growing credit and market risk it was assuming in its CDO and leveraged lending businesses. In the latter, underwriting standards were allowed to be diluted with senior management's acquiescence in an effort to remain a leader within the industry. The firm mistakenly relied on a belief that it could syndicate its exposures, without considering the consequences that a credit market dislocation could have until it was too late. Less than adequate attention was afforded to how the firm would manage a growth in assets, if distribution slowed, in relation to the utilization of balance sheet limits. It also did not properly highlight the funding and liquidity implications of on-boarding assets and, in the case of certain counterparty credit exposures such as liquidity puts that had been written to CDO conduits, under-measured their potential impact. Similarly the firm's contingency funding plans did not consider the potential impact of supporting Citi-advised Structured Investment Vehicles ("SIVs") for reputational reasons.

Senior management, as well as the Risk Management function charged with independent monitoring responsibilities, did not properly identify and analyze these risks in a timely fashion, and were slow in presenting them to the Board of Directors and the Audit & Risk Management Committee. The Board of Directors, in turn, does not appear to have posed the proper questions to senior management in the early stages of the subprime mortgage crisis, which otherwise might have caused senior management to report more meaningfully and completely on the potential impact on the firm's risk exposures and future earnings.

Exacerbating this situation was the fact that communication among the independent Risk Management function, business line management, and senior management on aggregated inherent subprime risk across portfolios and products proved to be inadequate when credit and market conditions deteriorated in 2007. This hampered timely recognition of the growing problems by senior management and the Board of Directors. Senior management incorrectly discounted the probability that the deterioration that was

becoming evident in the CDO market and in subprime credit conditions during the Spring and Summer of 2007 would have such a significant deleterious effect on the firm's valuation of its assets and its ability to syndicate problematic assets. While the firm ultimately released those managers whose businesses incurred the losses, some other remedial actions were slow in coming after the subprime CDO exposure was identified and its ramifications on earnings were announced. Two rounds of CDO write-downs were announced before a unit was formed to concentrate on loss mitigation and enhancing the CDO valuation process.

In assessing Policies, Procedures, and Limits, examiners recognize that these were appropriate for many businesses across the firm. However, policies, procedures and limit structures did not adequately address exposures and issues related to the convergence of credit and market risks, as for example, credit limits not capturing exposures arising from underlying subprime collateral in CDO-traded products. Also, limits were not consistent between the similar products of cash and synthetic CDOs. Moreover, limits were not designed in a way to identify or control concentrations in subprime exposure. Procedures in assessing the risk of the firm's CDO exposure placed an over-reliance on rating agencies and did not require sufficient scrutiny of the underlying assets. Management needs to reassess its policies, procedures, and limits to insure that they are commensurate with all the risks that the firm undertakes, and that they properly control activities or businesses where multiple risks converge.

Internal controls, such as those represented by an independent and effective Internal Audit function and Risk Management function, are critical to ensuring that business line management operate in a controlled environment where risk/reward decisions can be made in a fully informed fashion. The fundamental issue is the ability of the independent control functions to successfully challenge management. Within the Risk Management function, that clearly did not occur sufficiently in 2007. As senior management reassesses and reinforces the Risk Management function, attention to the stature and independence of the staff must be a high priority. Moreover, Internal Audit should insure that its audit plan is adjusted to review promptly new risk management or governance controls that are established, that the Risk Control Self Assessment ("RCSA") process in affected businesses is closely scrutinized, and that proper follow-up occurs with business line management regarding any adverse audit findings associated with such businesses where improvements are needed, such as in Structured Credit products.

In response to the risk management weaknesses and the consequent severe losses experienced, the firm has appointed a new Chief Risk Officer, restructured the CMB Risk Committee, appointed a Board liaison to Risk Management, and begun laying the groundwork for an improved approach to risk identification, measurement, and management. Moreover, the new CEO has indicated that the culture of the firm towards risk management must change such that senior business line management will be held more directly accountable for risk management and for incorporating all forms of risk into business decisions. These steps, along with others needed to insure that fulsome discussions of emerging risks take place in a timely and complete fashion at the senior

management and Board of Directors level, must be of the highest priority for senior management and the Board members.

Specific Areas of Risk Management Weakness

— CDOs

Management did not properly identify and assess its subprime risk in the CDO trading books, leading to significant losses. Serious deficiencies in risk management and controls were identified in the management of Super Senior CDO positions and other subprime-related traded credit products.

Existing risk controls and metrics were not adapted to the evolving, complex CDO business. Reporting metrics employed in Citigroup's MIS proved inadequate, and there was insufficient analysis behind the metrics for management to review. There was a significant flaw in the approach to stress testing, which was based on historical experience only, and was therefore not sufficient to capture the full range of outcomes that could happen with these relatively new and generally illiquid, infrequently traded CDO products. Additionally, over reliance was placed on rating agency data to assess the underlying CDO collateral, with inadequate efforts made to go beyond those ratings. Moreover, the valuation model for the pricing of Super Senior CDOs in inventory was not properly validated, and the limit structure for similar cash and synthetic CDO products were not applied consistently.

Risk Management failed to identify the growing subprime credit exposure concentration. In its annual real estate aggregation exercise in early 2007, it did not include the subprime risk posed by underlying CDO collateral. Senior management itself has conceded that communication between the market trading area which handled CDO trading and the CDO structuring area was inadequate, and therefore did not highlight in a timely manner the changes that were occurring in credit quality and distributive ability. This highlights a significant weakness in the internal risk management infrastructure, as well as in staff. Moreover, the CMB Risk Management Committee did not provide effective oversight as it did not regularly meet, and there were oversight failures by both the Capital Markets Approval Committee and the CMB Business Risk Practices Committee, mentioned later in this report. Finally, it should be noted that senior management was slow in establishing a dedicated subprime business unit to concentrate on the loss mitigation and flawed valuation model, not doing so until the second Super Senior CDO portfolio writedown announcement in early November.

As management works to correct deficiencies in risk controls and in communication within CMB and across the organization, it must enhance the oversight and critical analysis provided by the newly reconstituted CMB Risk Committee. Risk management must continually reassess the adequacy of existing risk controls and metrics to manage complex, evolving businesses, including the production and distribution of timely and

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informative reports to senior management and the Board of Directors that highlight large and/or illiquid positions or businesses with unusual growth or revenue.

— *Leveraged Finance*

During the rapid growth in the leveraged finance market, senior management was aware of changing credit fundamentals, yet did not adequately consider them in managing and mitigating the risks in the leveraged finance business. Underwriting standards were allowed to deteriorate to maintain market share, with the pipeline allowed to grow rapidly, thus exposing the firm to sizeable potential risks. The firm relied exclusively on its ability to distribute the assets as a mitigant to the pipeline risk. Little in the way of risk mitigation techniques or stress tests was utilized to assess the ability to distribute these exposures in changing markets. These fundamental control weaknesses contributed to the losses resulting from the sudden drop in demand for leveraged loans that occurred over the summer of 2007.

While notional limits served as a catalyst for initiating discussions to reassess risk appetite, they proved ineffective in controlling pipeline risk. The firm did acknowledge the higher risks associated with leveraged bridge finance commitments, and reported and discussed those exposures and limit increases with the Board of Directors. However, the same level of reporting and scrutiny was not given to the much larger leveraged loan pipeline, as these deals were assumed to be easily distributable to third party investors; hence underwriting commitment concentrations grew significantly over time without proper oversight.

Management needs to establish limits and controls that can effectively and timely identify and manage distribution and concentration risks, particularly in fast growing or changing markets. Strong fundamental credit analyses, along with limits that consider stressed conditions, are necessary for a sound risk control infrastructure.

— *Balance Sheet Management*

Senior management did not use sufficient discipline in managing balance sheet usage, which led to liquidity and capital management issues. Even when clear warning signs were present that substantial balance sheet growth, due to a rapid pace of acquisition activity, was straining the firm's capital position, limits were not enforced. By mid-2007, unconstrained asset growth began to significantly impact the organization's capital position. As of 2Q07, the firm's actual Tangible Common Equity/Risk Weighted Managed Asset ("TCE/RWMA") ratio was below management's internal target, and Tier 1 and Total Risk Based capital ratios for the third and fourth quarters were projected to be marginally above management's internal targets.

Senior management allowed business lines largely unchallenged access to the balance sheet to pursue revenue growth. Citigroup attained significant market share across numerous products, including leveraged finance and structured credit trading, utilizing

the balance sheet for its "originate to distribute" strategy. Senior management did not appropriately consider the potential balance sheet implications of this strategy in the case of market disruptions. Further, they did not adequately assess the potential negative impact of earnings volatility of these businesses on the firm's capital position. Although balance sheet limits existed, they often served only as triggers for discussion, with management viewing maintaining leadership positions in certain businesses as being more important than adhering to balance sheet constraints. Approved excesses were required only to be documented and were then eventually reported to corporate treasury. Further, the firm's internal transfer pricing system did not adequately charge businesses for building contingent exposures which could potentially impact funding and capital.

These shortcomings in balance sheet management were exposed by the subprime mortgage market crisis and resulted in significant tactical liquidity management challenges for the treasury function. Underestimated and/or unreported probabilities of funding certain off-balance sheet exposures (e.g. liquidity puts on CDO conduits and SIVs) and undistributed underwritings of leverage loans were a substantial challenge to corporate treasury.

In moving toward a centralized treasury function, management needs to establish discipline in the usage of the firm's balance sheet to ensure that sufficient financial resources and capital are maintained through both normal and stressed market conditions. Corporate treasury needs the ability to monitor, control and maintain optimal levels of balance sheet usage across the entire firm to limit unplanned funding. Senior management must also ensure that balance sheet management is considered part of management's overall business strategy, communicate this to business management, and provide the Board of Directors with sufficient information to assess how the firm is complying with its strategy. We note that senior management has significantly elevated concerns over balance sheet usage to the business lines and has begun to address these deficiencies.

Discussion of Risk Management Subcomponents

—Board and Senior Management Oversight

Board of Directors and Senior Management Oversight has been downgraded to "fair" from "satisfactory" based on an inadequate understanding of the risks taken by the firm and limited actions taken in the early stages of the subprime market crisis that were indicative of overall gaps in management oversight. These risks were significant, as the firm was forced to recognize sizeable writedowns in its structured credit and leveraged lending activities that undermined the adequacy of the firm's capital, caused the franchise to suffer severe reputational risk, and increased the potential future legal risk. Further, independent Risk Management did not have sufficient stature for escalation procedures to be an effective control mechanism in limiting risk taking by the business lines.

Market trends in the first quarter pointing to weaknesses in subprime lending, along with peer comparisons, should have focused the attention of senior management and the Board of Directors on subprime risk in all its forms across the firm's activities and the potential impact on capital levels. As the credit market crisis unfolded, senior management provided the Board of Directors with regular updates on subprime lending portfolios, exposures to subprime mortgages in originations, and leveraged bridge finance. However, there was little communication on the extensive level of subprime exposure posed by Super Senior CDOs, nor on the sizeable and growing inventory of non-bridge leveraged loans, nor the potential reputational risk emanating from SIVs which the firm either sponsored or supported. Senior management, as well as the independent Risk Management function charged with monitoring responsibilities, did not properly identify and analyze these risks in a timely fashion.

Decisions to actively utilize subprime collateral in CDOs and to form CDO conduits with super senior CDO exposures should have been referred to the Capital Markets Approval Committee or CMB's Business Risk Practices Committee for evaluation. There is little evidence to suggest that this occurred, and it indicates that these committees and the CMB Risk Committee were ineffective, along with the independent Risk Management function, in ensuring that new or changing risks were properly reviewed.

While we acknowledge that management took steps in prior years to minimize the firm's exposure to the more risky forms of direct mortgage lending such as option ARMs and non-amortizing loans, it did not recognize and control the concentration of subprime exposure that was building in its structured credit activities. Moreover, the Board of Directors does not appear to have posed the proper questions to senior management in the early stages of the subprime mortgage crisis, which otherwise might have caused senior management to report more meaningfully and completely on the potential impact that deteriorating credit market conditions could have on the firm's risk exposures and future earnings.

Large leveraged finance commitments were not fully considered in the context of weakened underwriting standards and the potential for reduced ability to distribute the pipeline risk. This resulted in unanticipated funding of failed syndications/distributions. These weaknesses highlight that senior management and Risk Management did not properly identify the convergence of market and credit risks in these products. Management's focus was primarily on revenue generation until it became clear that the credit market conditions had changed so significantly that the ability of the business to operate in a "business as usual" mode was being seriously disrupted.

The onboarding of assets from leverage finance, CDO exposures, and SIVs contributed to already existing balance sheet growth issues arising from acquisitions and tacit approvals of limit breeches to support generation of revenue. The deliberations of the FinALCO Committee did not prove to be an effective constraint on the growth of the firm, despite the presence of balance sheet limits, as management routinely increased them to accommodate additional revenue generation. Inadequate/limited oversight by senior management in maintaining control over the growth in the balance sheet created

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increasing funding and liquidity risks, and also diminished the firm's regulatory capital ratios.

—Policies, Procedures, and Limits

We are downgrading our assessment of corporate level policies, procedures and overall limits to "fair" as they did not provide adequate guidance to maintain controls commensurate with the level of risk, and did not adequately address exposures and issues related to the convergence of credit and market risks. They also did not provide for the factoring of asset illiquidity into the sizing of leverage loan underwriting limits. Procedures were lacking in the firm's approach to aggregating exposures under firm-wide mortgage limits, as subprime collateral risk underlying CDOs was excluded due to identification and measurement difficulties.

While the corporate limit framework includes an annual review process and reflects the firm's risk appetite, serious weaknesses were noted in the capturing of Super Senior CDO and leverage loan exposures. Consistent limits were not established for assets that were similar, such as cash and synthetic CDOs. Market risk stress limits also did not adequately reflect the Super Senior CDO positions, including the liquidity puts for CDO conduits, as stress testing was built on historical data that did not adequately capture the true potential risks of these relatively new products. The failure to reflect the proper market volatility constrained the firm's ability to understand the risks it had assumed.

With respect to leveraged lending, neither the firm's prudential risk appetite, nor the potential funding requirements for the leveraged lending pipeline, were appropriately considered when underwriting limits were aggressively increased from $25 billion to potentially $100 billion notional in March 2007 to maintain league leadership positions.

In its approach to balance sheet management limits, excesses/increases in balance sheet limits were not treated as a serious cause for action, only requiring that they be documented and reported to Corporate Treasury. Further, the firm's internal transfer pricing system, by not charging businesses for building contingent exposures which could impact funding, did not reinforce discipline in the process. Unanticipated balance sheet usage within businesses (funding leveraged loans, CDO conduits and onboarding SIV assets) resulted in significant tactical liquidity management challenges for Corporate Treasury. While Citigroup has thus far been able to obtain the funding needed to support the balance sheet growth, it has had to do so at a time when obtaining wholesale long-term funding is both expensive and difficult, and is occurring in the shadow of past and perhaps future rating downgrades. Moreover, it has strained the firm's overall liquidity position, and caused it to fall out of compliance for long periods of time with its own liquidity guidelines at both the bank and at the "consolidated non-bank."

Although asset liquidity is periodically reviewed as part of the Contingency Funding Plan, management will need to consider enhancements to better assess the liquidity characteristics of new products and to account for reduced asset liquidity under broader stressed market conditions that go beyond just Citigroup-specific events. Management

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will also need to instill greater discipline in the process of administering its liquidity guidelines such that non-compliance with the limits receives greater attention by senior management and the Board of Directors.

—Risk Monitoring and MIS

Risk monitoring and MIS reporting is downgraded to "fair" as weaknesses in risk monitoring practices contributed to the ineffective identification of significant traded credit risk and other adverse trends.

A substantial amount of the Super Senior CDO positions were not captured in Citigroup's VaR model until recently. Further, the firm's use of a statistically based stress testing methodology was not appropriate for Super Senior CDOs, which are illiquid and have a limited historical price history. The result was an understatement of risk in the main tools used by the firm to communicate the CMB's risk to senior management.

Credit MIS reporting captured the firm's major credit-related risks but was ineffective in highlighting the increasing concentration that was occurring in the leveraged loan commitment pipeline. Further, results of our monitoring efforts in 2007 suggest that aspects of counterparty credit stress testing lags peers and needs enhancement. In the case of the CDO conduits, inadequate stress testing hindered the monitoring and reporting of the increasing probability of the firm having to fund the exposure.

The credit market crisis highlighted necessary enhancements to the quarterly corporate level liquidity stress testing to better prioritize funding alternatives in a liquidity crisis. Enhancements are needed to better capture off-balance sheet contingencies, to anticipate disruptions in the distribution of assets, and to factor in potential funding requirements in cases where the firm's reputation could suffer if support were not extended.

—-Internal Controls

Internal controls are being downgraded from "satisfactory" to "fair." While this component of risk management normally focuses primarily on the effectiveness, quality, and independence of Internal Audit, weaknesses exhibited within the firm's independent Risk Management function can be, and in this case are, equally indicative of a failure of internal controls within the institution. Risk Management's ability to carry out its critical mandate, namely to ensure that business line management operates in a controlled environment where risk/reward decisions are made in a fully informed fashion and where business line decisions can be successfully challenged, was clearly insufficient in 2007. The risk management weaknesses displayed and discussed in this report were material to the CMB business, and had severe ramifications for the firm overall. Moreover, there are questions as to why some of the internal audit controls and the RCSA processes were not more effective in highlighting weaknesses that are discussed in this report. Internal Audit needs to reexamine the effectiveness of the RCSA process in the areas that are criticized

in this report, and apply a "lessons learned" approach to the broader set of RCSA processes that exist across the firm.

Within a more narrow set of observations concerning internal controls, model validation, specifically for market and credit risk models, was a work-in-process for the firm in 2007 with regard to upgrading review parameters, decreasing model review backlogs and addressing staffing deficiencies. Adherence to policies defining the ability to rely on models prior to the required level of validation was lax and remains a continuing challenge with the existent backlog. For example, the model for Super Senior CDOs, based on fundamental economic factors, could not be fully validated by Citigroup's current validation methodologies yet it was relied upon for reporting exposures. The Discounted Cash Flow model was not used in a controlled environment, developer documentation was imprecise, and testing results and analysis were limited. The inability of the firm to fully assess its CDO exposure was, in part, attributable to these modeling difficulties. Similarly, the firm's failure to properly "charge" the businesses for generating contingent claims on the balance sheet such that the activity could be viewed through the proper risk/reward prism and be properly captured in the firm's contingency funding plans, represents a further internal control weakness.

<u>Other Supervisory Considerations</u>

Compliance Risk Management and Anti-Money Laundering ("AML") Programs

We acknowledge that Global Compliance management has taken several steps designed to strengthen the compliance infrastructure and enhance the control environment. We are encouraged that the reorganization of the Global Compliance function will allow the firm to swiftly address issues as they arise. In-business compliance programs will be optimized by consolidating reporting lines and reducing redundant processes. Moreover, while still relatively new, the creation of firm-wide Shared Utilities for Compliance is a thoughtful, systematic approach to governance across Citigroup's large, geographically diverse structure. These Utilities are intended to eliminate communication silos, promote internal best practices, leverage existing resources, and combine similar functions.

Our review of compliance monitoring, testing and reporting ("MTR") confirmed the comprehensiveness of both Citigroup's overall MTR framework and the sector-specific programs. We also found that the compliance programs in the sectors examined conformed substantively to internal guidance.

Regarding compliance with AML programs, oversight continues to improve and mature. Progress has been made in the way in which certain measurable benchmarking tools have been developed and used by Global AML to test, compare and contrast how well AML risk controls are working throughout the firm. The restructuring of Global AML and the recognition of AML as a Shared Utility allows for closer alignment with the businesses

and facilitates greater oversight and influence by the regional and global AML heads on how in-business AML programs are carried out.

We view favorably the establishment of the regional AML hubs in Warsaw and Kuala Lumpur, as the regions they service should benefit from the increased capacity and enhanced monitoring capabilities. Since the AML technology initiative is a multi-year effort, management is encouraged to continue to evaluate its automation needs as it strives to more effectively monitor and detect unusual and suspicious activity.

Compliance with Fair Lending Laws

From a review of CitiFinancial's consumer finance and mortgage businesses in Puerto Rico, examiners noted the following two discriminatory practices: the requirement for a non-applicant spouse to sign the promissory note on real estate-secured loans, and limiting the signage on unsecured loans to co-applicant spouses. Not only are these practices discriminatory under fair lending laws, but they are also violations of provisions of Regulation B. Consequently, and consistent with supervisory requirements, the matter has been referred to the Department of Justice for further review.

Information Technology

Senior management continues to take steps to strengthen Citigroup's technology infrastructure, but the technology organization still has its challenges. Overall technology execution risk is high and includes a number of significant integration efforts across the firm, as well as an IT risk re-engineering effort. The examination of Information Security conducted with the OCC noted that the IS program was satisfactory, but identified areas where further efforts were required to strengthen key elements of the program. Although the number of IS related audit issues identified have declined in comparison to 2006, the number of issues still remains high, with one in every four audit reports containing an IS audit issue. These efforts will put pressure on management's ability to continue to deliver on its strategic goals and therefore must be monitored closely throughout the year. Management must also ensure that appropriate technology risk management tools are in place to support the governance of these activities across the firm.

Allowance for Loan and Lease Losses ("ALLL")

Citigroup's consumer loan loss reserve methodology continues to be enhanced with efforts taken to incorporate inherent credit losses for certain performing portfolios in the firm's straight rate ("SR") calculation. In addition, analytical work with regard to defining when a loss event has been incurred prior to delinquency was done and supplements the SR calculation. Efforts continue in developing and implementing alternative models to better estimate expected losses such as those within the firm's auto and mortgage portfolios. These enhancements, along with greater use of management adjustments to fully capture inherent credit losses not incorporated in the SR methodology, are positive measures. Such management adjustments must be well documented and consistently applied across the portfolios.

Basel II

We recognize management's continued efforts to implement the Basel II capital adequacy framework, which includes appropriate oversight provided by the project management office as well as comprehensive reporting of the status of associated implementation risks. Our examination efforts will help to further our understanding of the framework and associated challenges, such as data quality and technology limitations with regard to wholesale and retail credit exposures. These data and technology shortfalls could negatively impact the firm's ability to successfully move forward with their implementation efforts, and continued vigilance in resolving these shortfalls must be a priority of senior management.

Progress continues in implementing the operational risk management processes, which were assessed as satisfactory by examiners from the FRBNY and OCC. However, the quantification methodology used to estimate operational risk capital needs to be re-evaluated given the reliance on the model in selecting final tail parameters.

Over the coming months, we look to continue our dialogue with management on these efforts, including applicable home-host issues.

FINANCIAL CONDITION

The firm's overall financial condition has been downgraded from "strong" to "fair." The uncertainty of the direct and indirect implications of the evolving subprime mortgage credit crisis on Citigroup's earnings generation capability, the potential exposure of its capital base to further erosion, its strained liquidity position, and the need for the firm to carefully manage its balance sheet going forward, all cause us to view the firm's present overall financial condition as "fair" and deserving of more than usual supervisory attention.

After a record earnings performance in the 2nd quarter, Citigroup's overall financial condition deteriorated markedly. It suffered mediocre earnings in the 3rd quarter and then proceeded to post record losses in the 4th quarter due primarily to write-downs in its subprime mortgage-related CDOs and growing net credit losses, especially in the consumer loan portfolio. These losses, in conjunction with the rapid asset growth strategy senior management pursued in 2006-2007, reduced Citigroup's capital to levels that, while still considered "well-capitalized" by formal supervisory standards, were below internally-set targets. The losses also caused external rating agencies to question the capacity of the firm's capital to absorb future losses. This occurred after a period of several years whereby the firm's capital ratios had drifted steadily downward, leaving the firm with little cushion to absorb the magnitude of unanticipated losses. It also occurred despite the firm having raised $15 billion in various forms of additional capital during the year from outside investors. As a consequence, the firm was forced to seek additional capital in January 2008 and raised $19.4 billion, which restored the bank's capital to levels above internal targets.

Citigroup will be severely challenged going forward in seeking to ensure that its future earnings and capital base are consistent with its growth and strategic plans. It is facing the prospect of rising net credit losses in the consumer business and further writedowns of uncertain magnitude in its structured credit holdings. Indeed, as this report was being finalized, the firm expects to once again announce significant losses for the first quarter 2008, again tied to writedowns in its super senior CDOs and its leveraged loan portfolios, as well as a continued need to set aside significant loan loss reserves. Moreover, signs of weakness in the firm's international operations, traditionally a source of steady contributions to net income, have started to appear. Although the firm has taken action to strengthen its capital base, the salutary effects on its ability to absorb unanticipated losses could be of limited duration. The financial condition of the organization and its access to the capital markets will likely deteriorate if the firm's earnings cannot protect and add to the capital buffer that now exists.

The probability of further writedowns in its subprime related exposures, the need to continue to set aside increasing provisions for corporate and consumer loan losses, and uncertainty over the need to recognize later this year a large one-time reserve for its Japanese consumer operations, all weigh heavily against the firm achieving a level of earnings that can maintain capital at present levels. Should the firm be unable to reestablish confidence in its ability to generate consistent and reasonable earnings comparable to its peers, its ability to raise capital could be impaired, thus placing the firm in jeopardy of once again falling below internal targets and possibly supervisory minimums. Perhaps more importantly and of a more immediate nature, any lack of confidence in the firm's ability to remain well-capitalized or maintain its internal capital targets could quickly and negatively impact access to the short-term funding markets, extending even to its ability to obtain secured financing, given present unstable credit market conditions.

Capital

Capital has been downgraded from strong to fair. Citigroup's regulatory capital ratios declined steeply in 2007 owing to aggressive asset expansion outpacing earnings retention and equity growth. This decline only exacerbated the already unfavorable comparison to peers in a number of the capital measures. Throughout the year, the firm's capital base, as measured by these ratios, steadily eroded and was particularly affected by the significant losses incurred in the 4th quarter in its subprime related CDO holdings and growing net credit losses in its consumer loan portfolio. Supervisory risk-based capital ratios fell below internal targets and the TCE/RWMA ratio scrutinized by the rating agencies likewise fell below the internal target, despite the firm raising $15 billion in additional capital during the year. As a result, in January 2008 the firm issued further equity in the amount of $19.4 billion in preferred capital from a mix of private and public investors. This helped restore the firm's capital position to levels above its internal targets. In addition, Citigroup announced a reduction in its dividend by 40% so as to relieve future stress on its capital base.

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Citigroup's projected Tier 1 and Total Risk-Based Capital ratios for the year are expected by management to remain above internal targets, in part reflecting planned asset divestitures, careful balance sheet management, and the reduced dividend payout ratio. (The TCE ratio is not expected to meet target levels until mid-year.) However, the firm's earnings forecasts have consistently portrayed an increasingly negative direction for 2008 as the outlook for economic conditions worsened, and first quarter earnings are expected to reflect another significant loss. Given the uncertain probabilities surrounding the forecasted events, worsening economic conditions that will affect the firm's profitability, and the likelihood that there will continue to be large and perhaps unanticipated losses due to the unfolding credit crisis, it is uncertain that the firm can achieve a level of earnings that will maintain capital at present levels.

We note that the firm's own internal measure of risk in its businesses, as indicated by economic risk capital, grew 48% in 2007 indicating the risk of the firm's business has continued to grow, far outstripping Tier 1 capital growth even after accounting for January's capital infusion. We also note that some restricted core capital currently treated as Tier 1 capital may not receive a Tier 1 capital designation after March 31, 2009. Federal Reserve Board rules provide that as of that date, internationally-active bank holding companies such as Citigroup must have a ratio of restricted core capital elements (excluding mandatory convertible preferred securities) to Tier 1 capital of not more than 15%. At December 31, 2007, Citigroup's restricted core capital ratio was 20.6%, and although it has subsequently been reduced, the firm's flexibility managing to this constraint is narrow.

Considering all of the above, it is our view that the capital position of the firm requires more than normal supervisory attention and is therefore considered only fair.

Asset Quality

Citigroup's asset quality is downgraded from "strong" to "satisfactory," with continued deterioration likely in 2008. Overall, Citigroup's wholesale exposures account for roughly 70% of the firm's credit portfolio with the composition of corporate exposures rated investment-grade remaining high at 84%, even while corporate exposures increased by 20% over the year.

However, pockets of rising classified assets in the corporate portfolio, such as leveraged loans and financial guarantors, have appeared and potentially could contribute materially to future credit losses. Weighted classified assets as a percentage of Tier 1 capital plus the ALLL was 6.61% as of year-end 2007, a sharp increase from 3.56% in the prior-year period. However, it remains fairly modest on a historical–basis. The firm has experienced increasing criticized assets, delinquency rates, non-performing assets and net charge-offs, particularly in the consumer portfolio. Nonperforming assets to total loans have increased to 0.58% in 2007, in contrast to steady declines in 2006.

Within the consumer group, the firm's home equity portfolio continues to show significant weakness, along with rising delinquency trends being experienced in the auto

and personal installment lending portfolios. While noting the overall negative credit trends within the consumer portfolios, the CitiFinancial mortgage portfolio has performed better than peer. This is due in part to tighter underwriting criteria on documentation, loan-to-value, and debt-to-income levels, along with less reliance on third party origination channels. In addition, management's decision not to originate the more risky exotic mortgages such as option ARMS and non-amortizing loans benefited CitiFinancial's overall performance, given those products' significant deterioration. The firm has tightened underwriting criteria and has moved away from broker and correspondent channels, instead focusing its origination efforts through its own retail branch network which should ameliorate expected future deterioration.

Earnings

Citigroup's earnings performance has been downgraded from "strong" to "marginal." In 2007, consolidated earnings dropped precipitously by 83% year-over-year to $3.6 billion. The year's underperformance was due largely to the 4th quarter loss of $9.8 billion related to CDO direct subprime exposures. Consequently, ROAA fell to 0.17% (1.3% in 2006) and ROE fell to 2.9% (18.6% in 2006). Citigroup's earnings performance compared unfavorably to that of its peers. Citigroup's earnings were clearly not sufficient to make full provision for the absorption of losses and the accretion of capital in relation to company growth, as evidenced by the need for significant capital infusions in late 2007 and early 2008. Moreover, we note that the firm's earnings failed to cover common dividends paid to shareholders for the year and, as currently forecasted, may not be sufficient to do so in 2008. This calls into question whether the firm will be able to meet the expectation embedded in Federal Reserve System policy that common dividends be funded from current earnings.

Although Citigroup's diverse geographic operations continued to be a source of fairly reliable earnings support, it was insufficient to offset losses from its US operations. As noted elsewhere in this report however, signs of stress are showing up abroad as well, with a 23% drop in international net income for 2007.

Although the 4th quarter CDO write-downs may be considered an outlier event in terms of size, earnings forecasts from the firm have shown an increasingly pessimistic picture as economic and financial assumptions have become increasingly negative. As noted earlier, estimates for the first quarter now reflect another significant loss. There is considerable uncertainty about the firm's ability to achieve a steady stream of earnings for the remainder of 2008 in the face of an economic downturn. The fact that former high earning businesses (e.g. structured credit and leveraged lending) are not likely to recover in the near future will likely pressure earnings going forward. Other high performing lines of business in 2007, such as International Cards, Global Transaction Services and Global Wealth Management may come under pressure in the face of a domestic or global recessionary environment. Moreover, as the effects of the subprime mortgage market situation continue to work their way through the financial landscape, Citigroup faces the distinct possibility of further writedowns to its structured credit portfolios, increased credit losses in its consumer and wholesale loan portfolios, and potential litigation and

legal expenses stemming from the subprime crisis. There is also the possible need for a significant pre-tax writedown of $6 billion on the Japanese consumer finance portfolio later in the year.

In summary, Citigroup's recent poor earnings performance in the latter half of 2007 and into the first quarter 2008 increases pressure on it to reestablish an earnings level that provides capital protection and accretion and to more effectively manage its balance sheet to protect its capital buffer against erosion.

Liquidity

Our assessment of Citigroup's overall liquidity position has been downgraded from "strong" to "fair." The downgrade is a result of declines in structural liquidity at the firm resulting from funding significant balance sheet growth over the last year, persistent funding gaps at the bank exceeding limits across several tenors during the second half of 2007 and into the first quarter of 2008, and the potentially damaging effect on the firm's access to funding sources given future market reaction to continued losses.

Substantial balance sheet growth occurred during the third and fourth quarter 2007 subprime market crisis as significant amounts of unplanned assets came on balance sheet. These assets included $25 billion in commercial paper issued by third party CDO conduits (backed by liquidity puts written by Citigroup), $30 billion in illiquid syndicated leveraged loans, and $59 billion in Structured Investment Vehicles (SIVs). The firm used a portion of its contingent funding capacity to fund the unanticipated on-boarding of assets arising from these decisions.

Structural liquidity reductions are further highlighted in the internal aggregate <u>bank</u> cash-capital ratio deterioration since the second quarter of 2007 from 120% to 104% at year-end 2007, reflecting a higher proportion of illiquid assets relative to long-term funding. Within the consolidated <u>non-bank</u> portion of the firm, Citigroup has been operating below an internal short-term target ratio of 110% following months of a downward trend that began in 1Q07. The broker-dealer's cash capital ratio has been below the target of 120% since Sept 2007. Cash positions at the broker dealer at the end of March 2008 were just under $17 billion, and the liquidity portfolio at the parent bank holding company was only $14.1 billion. The adequacy of these levels should be reviewed given the size of the firm and its importance to the financial markets.

Since the third quarter, the bank has been operating with funding gaps that exceed Market Access Reporting ("MAR") limits across tenors, and has thus been operating in excess of its funding cushion. At times these excesses have become quite large, exceeding $50 billion or 175% of the limit. While the bank had taken steps to improve the management of the gaps, these steps proved temporary due to the on-boarding of assets that subsequently occurred, and downward adjustments to the limits prompted by reduced contingent funding sources. Very recently, the bank has been successful in eliminating most excesses under pressure from its primary regulator, but by the bank's own

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admission, there continue to be little in the way of a liquidity buffer to protect against potential liquidity commitments.

Although the firm continues to have access to a variety of funding sources on comparatively favorable terms, its liquidity position is at risk given the reputational effects that might arise from the firm's negative earnings prospects. Furthermore, ability to access the funding markets may be made more price-sensitive should further credit rating deterioration occur. Debt ratings in 2007 were downgraded both at Citigroup and Citibank, N.A.. Moody's Investor Services downgraded Citigroup's senior debt rating two notches from Aa1 to Aa3. Citibank N.A.'s debt rating was also lowered from Aaa to Aa1. In early 2008, Standard & Poor's downgraded Citigroup from AA to AA-, and Citibank N.A. from AA+ to AA. These downgrades resulted from weak projected earnings and capital deterioration concerns. Citigroup now has a lower senior debt rating than its peers. Further debt rating downgrades may unfavorably impact access to funds on favorable terms, restrict the supply of available credit, or lead to deposit erosion.

Management will need to promptly carry through with its plans to reduce assets and de-leverage the balance sheet so as to improve its overall structural liquidity position and improve its ability to meet its own targeted minimum liquidity goals. Citigroup needs to increase its liquidity sources wherever possible and develop an adequate liquidity portfolio that could withstand severely stressed market conditions. Management should also continue to ensure consistent adherence to its bank MAR funding gap limits, as it committed recently to its primary bank regulator.

IMPACT RATING

The likelihood of a potential significant negative impact on subsidiary depository institutions from the parent company and nonbank subsidiaries is considered "limited" (or rated 2), same as at last examination. This assessment reflects observed financial support provided to the bank subsidiary from the parent company and broker/dealer subsidiary and actions taken to reduce the parent company's operating cash requirements. Moreover, there is little evidence to suggest that from a legal, reputational, or financial perspective, the nonbank subsidiaries of Citigroup negatively impact the affiliated depository institutions. Prospectively however, there is greater uncertainty regarding the parent company's capacity to generate operating cash income through dividends from subsidiaries in 2008, given the potential for future earnings volatility brought about by slower U.S. economic growth. This has negative connotations for the parent company as it is reliant on dividend income from subsidiaries to meet operating cash requirements.

Parent company operating cash flow after the payment of common stock dividends declined in 2007 driven by reductions in dividends from bank and broker/dealer subsidiaries. These decreases were in support of bank subsidiary capital retention driven by asset growth and in response to fourth quarter 2007 net losses. In response to diminished operating cash flow capacity at the parent company in 2007, parent company

operating cash requirements were significantly reduced through a 40% reduction in the quarterly common stock dividend payment for 2008.

The parent company and broker/dealer subsidiaries have acted as a source of financial strength to the bank subsidiary as financial resources have been diverted to support bank subsidiary operations. During 2007, approximately $25 billion in equity capital was invested in Citibank N.A. by the parent company to support asset growth and to build capital in response to significant net losses incurred in the fourth quarter. In addition, financial resources of the broker/dealer subsidiary were used to partially fund the parent company's fourth quarter capital injection into the primary bank subsidiary. The parent company's capacity to act as a source of financial strength to its bank subsidiaries was also evidenced through capital raising efforts in December 2007 and January 2008. The parent company raised approximately $30 billion in capital over a two month period through the issuance of mandatory convertible securities, enhanced trust preferred securities and perpetual preferred equity.

Significant asset growth at the bank and broker/dealer subsidiaries substantially increased the degree of financial leverage and double leverage at the parent company in 2007. These leverage measurements were higher than peers and highlight the parent company's reliance on dividends from subsidiaries to support operating cash requirements. Management's recent capital raising efforts however, have reduced these levels going into 2008. Looking forward, there is greater uncertainty regarding the parent company's future capacity to upstream dividends from bank and nonbank subsidiaries given a demonstrated higher degree of earnings volatility versus peers and the increased probability of slower economic growth in 2008.

DEPOSITORY INSTITUTIONS' RATING

Overall, the national banking subsidiaries are now considered by the OCC to be in "fair" condition (or rated 3), downgraded from "satisfactory." This rating is largely based on the evaluation of Citibank, N.A. Nevada, given its asset size relative to the other banks. The bank has suffered from the same risk management weaknesses and financial exposures that have been cited at the consolidated holding company level in this report. Accordingly, its capital, management, earnings, liquidity, and interest rate risk sensitivity have all been downgraded. Other banking subsidiaries -- including Department Stores National Bank, Citibank (South Dakota), N.A, Citicorp Trust Bank, FSB; and Citigroup Trust Delaware, N.A. -- are still considered in overall satisfactory condition.

CAMEO-- Rating of the Edge Act Corporation

The overall condition of Citibank Overseas Investment Corporation ("COIC") remains "satisfactory" and reflects similar assessments of capital, asset quality, earnings, and operational controls. COIC has made considerable progress in reconciling global policies, practices, and procedures with relevant local laws, regulations, and other considerations. Nevertheless, recently announced management issues at Citigroup indicate governance weaknesses within the consolidated Citigroup organization, and COIC by virtue of its structural integration is exposed to them. Accordingly, we have adjusted the management rating of COIC to "fair."

CAMEO RATING	12/31/2007	12/31/2006
Composite Rating	2	2
Component Ratings:		
Capital	2	1
Asset Quality	2	2
Management	3	2
Earnings	2	1
Operational Controls	2	2

Capital

Capital is downgraded to "satisfactory" from "strong." Management has not ensured that earnings performance and capital formation has kept pace with management's recent and planned asset growth. Consequently, COIC's Tier 1 and Total Capital ratios declined 264 and 247 basis points year-over-year to 15.9% and 17.23% at December 31, 2007, respectively. More notably, capital and leverage ratios now trail those at peer Edge Act corporations and the quality of COIC's parental strength and support are potentially weakened, as capital strength at the overall consolidated holding company has deteriorated.

Asset Quality

Asset quality remains "satisfactory." Classified assets as a percentage of Tier 1 capital remain well under 1%, similar to last year. By year-end 2007, total assets grew 41% year-over-year to nearly $482 billion, of which 40% consists of loans, 32% in placements with related entities, and the remainder in cash, Fed funds, securities, trade financings and other assets. Although the level of total classified assets remained roughly the same since year-end 2006, some credit deterioration is apparent (e.g., Japan, Brazil, United

Kingdom, and India). Since year-end 2006, past due and non-accrual loans have nearly doubled, increasing 107 basis points to 3.23% of loans. Similarly, although the ALLL grew nearly 70%, the balance now covers 55% of past due and nonaccrual loans, reflecting a 10 basis point drop since year-end 2006.

Management

Management is downgraded to "fair" from "satisfactory." In recent years, head office and local Board and senior management have made a concerted effort to strengthen risk management and the corporate governance framework. Management continues to demonstrate a commitment to enhancing the control environment by addressing audit and examination findings. However, this report highlights serious risk management issues at Citigroup needing correction that extend across the consolidated organization and affect management processes at COIC. Management oversight of the Edge's expanded geographical footprint must not be allowed to suffer under Citigroup's internationally decentralized management approach while these issues are being addressed.

Earnings

Earnings are downgraded to "satisfactory" from "strong." Management has not demonstrated an ability to sustain earnings growth relevant to COIC's recent asset growth and pace of acquisitions. Although net interest income and non-interest income grew 33% year-over-year in 2007, net revenues did not keep pace with COIC's 41% growth in total assets or 37% growth in overhead expenses. Over the same period, the company's loan loss provisions grew nearly 70%, with net income growing 15% to $5.3 billion – slightly above the level of earnings at much smaller peer institutions. Consequently, total profit margins slipped and ROAA and ROE fell 20 bp and 53 bp year-over-year to 1.3% and 11.06%, respectively, both of which trail peer averages.

Operational Controls

Operational controls remain "satisfactory." The company's written policies and procedures are adequate for the size and complexity of the organization and reflect relevant local laws, regulations, and other considerations within COIC's geographical footprint. The internal audit function adequately strengthens the control environment, which is complemented by a firm-wide RCSA process.

The company's risk monitoring processes and MIS are adequate. Local and head office senior level committees and business line management use risk management reports at appropriate intervals to support managerial decisions. Nevertheless, management needs to remain vigilant in ensuring risk management processes keep pace with the company's size and evolving risk profile, particularly with AML and credit risk monitoring.
Management is also faced with enhancing COIC's AML programs and IT management processes to support the increased size and geographical reach of the institution. AML due diligence, business continuity planning, and IT risk assessments are currently being updated to more appropriately correspond with the company's present operations.

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SUPERVISORY ACTIVITIES IN 2007

The Federal Reserve's supervisory program is accomplished through a combination of continuous monitoring by a core team of resident examiners and a series of more formal targeted examinations. In addition to periodic meetings with management, the core team has access to a significant amount of internal financial and risk management information. Analysis of that information enables the team to keep abreast of changes in the firm's business strategy, management structure, and risk profile. The review of internal risk management reports is a critical element of our supervisory process. Reliance also is placed on the supervisory work of the primary bank regulator, functional supervisors, and foreign regulators. Supervisory information received from those sources is factored into our annual assessment of Citigroup.

Scope of Reviews

Compliance Risk Management

- **Compliance Monitoring, Testing and Reporting (MTR).** The key objective of the review was to assess the implementation of the global Compliance Standards for Monitoring and Testing Directive. With respect to compliance monitoring, examiners focused on key risk indicators, participation by Compliance management on critical governance committees, and other documentation of monitoring activities. The methodology and documentation of compliance testing was reviewed through random sampling of recent tests conducted across the four business sectors. The activities of the Compliance Testing and Advisory group were assessed, as was the adequacy of reporting mechanisms and information-sharing channels used to disseminate results of compliance monitoring and testing.

- **CitiFinancial Auto ("CFA").** Examiners sought to identify the fair lending risks inherent in the CFA business, evaluate the fair lending risk management program used to mitigate such risks, and assess board oversight and board level reporting systems of fair lending and consumer compliance issues and controls.

Operational Risk Management

- **Financial Controls.** The key objective of the review was to assess the status of the corrective actions designed by Citigroup in response to the findings from the June 6, 2006 Regulatory Reporting Review. Examiners evaluated the development and implementation of account descriptions for Citibank NA's Tampa general ledger. Examiners also reviewed the new general ledger account opening policies and procedures and the new internet based TGL Account Definitions database.

- **Payment/Liquidity Horizontal Review**: The objective of this review was to evaluate the operational processes and management challenges in assessing the daily intra-day liquidity needs at large firms focusing on sources of intra-day funding, the monitoring of liquidity, the provision of credit, business continuity planning, the capacity planning process for key systems.

- **EMEA/UK and Egg Integration Examination.** The review focused on consumer credit risk management practices in the EMEA region, including regional governance of risk management practices and the quality of risk management in the UK-based consumer products. It also encompassed a review of the integration of the Egg Banking plc business into the existing consumer business in the UK, both from a strategic and technology integration perspective.

- **Singapore/Hong Kong Data Center Visitation.** The visitation was conducted to obtain an understanding of the Global Data Center Strategy, particularly for Singapore, and to determine the status of the Hong Kong data center migration plans. It also involved a review the Asia Pacific technology governance structure, a high level review of the International Technology Organization, and meetings with representatives of MAS and HKMA to discuss supervisory views of Citigroup's local IT operations.

- **India Franchise Review.** This review was conducted with the OCC and focused on retail credit risk management practices, given the rapid expansion of the consumer finance business in India. The FRBNY also focused on AML practices in the Non-Resident Indian and CMB businesses, as well as on franchise governance.

- **South Korea Franchise Review***:* This was an independent review of small/medium enterprise ("SME") lending, IT, AML, and franchise governance. SME operations are still in transition with newly introduced policies and procedures. The IT review assessed the effectiveness of the localized data processing center that Citigroup built according to local regulatory requirements.

Market Risk Management Review

- **Citigroup Energy Inc.** The focus of this discovery review was to understand the strategy and direction of this relatively new entity and review the control structure surrounding the Power and Gas trading activities. Particular emphasis was placed on market risk management, financial controls and the operational controls on physical commodities.

Credit Risk Reviews

- **ALLL:** Examiners conducted a review of the ALLL process for certain consumer portfolios within Banamex, CitiFinancial, and select COIC subsidiaries. The review included an assessment of the firm's processes for measuring inherent credit losses, including the straight rate method and management adjustments.

- **Continuous Monitoring Event: Russia:** This continuous monitoring event focused on credit risk management practices, given the rapid expansion of credit card and retail bank businesses in Russia, as well as on a high-level review of governance. AML practices were also reviewed, given Russia's cash-intensive economy and local considerations that give rise to elevated AML risk.

Basel II / Economic Capital Discovery Reviews

- **Basel II: Credit Risk (Wholesale and Retail).** Discovery reviews, often joint with the OCC, were held to assess Citigroup's risk management efforts related to wholesale and retail exposures to better understand plans to implement the Basel II framework. Examiners focused on processes associated with the quantification of Basel II parameters (PD, LGD, and EAD). In addition, the reviews also included the model validation process and associated controls for credit risk/ Basel II models.

- **Operational Risk Management.** This was a joint review conducted with the OCC to evaluate the overall quality of Citigroup's operational risk management, and progress in implementing the advanced operational risk measurement approach.

- **Economic Capital Horizontal.** The aim of this horizontal review was to understand better Citigroup's key processes for determining economic capital (EC). Aspects of the review covered the underlying methodology for calculating and aggregating EC for all material risks, the uses of EC, and EC governance processes.